

**SLOVAKIA HOUSING LOAN
RECOVERY ROUNDTABLE**

**SUMMARY OF PROCEEDINGS
AND STATUS OF LOAN
RECOVERY WORKING GROUP**

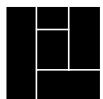
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SLOVAKIA HOUSING LOAN RECOVERY ROUNDTABLE

SUMMARY OF PROCEEDINGS AND STATUS OF LOAN RECOVERY WORKING GROUP

INTRODUCTION

The purpose of this memo is to fulfil the reporting requirements for RFS 709 with regard to the Housing Loan Recovery Roundtable. The RFS calls for a summary of proceedings and a discussion of a potential loan recovery working group to be formed as a result of the Roundtable.

The agenda for the Roundtable is attached as Annex A to this report, and was distributed to invitees before the Roundtable took place. In addition, a background paper entitled: *The Legal Basis for Housing Loan Recovery in Slovakia and Central and Eastern Europe: Changing to a Market-Based System* was prepared, translated, and distributed to participants in advance. That paper is attached as Annex B of this report. Some short remarks were prepared by a Western European mortgage banking expert, Dr. Klaus Peter Follak, who participated in the Roundtable. His remarks and recommendations are attached as Annex C to this report. The list of attendees is attached to this report as Annex D.

The objective of the Roundtable was to promote a common understanding of the loan recovery environment, in particular the Law on Execution and Enforcement Procedures and related legislation, in order to strengthen implementation of the laws and the development of effective mortgage loan recovery procedures in Slovakia. It built upon earlier regional efforts to strengthen housing loan recovery in Central and Eastern Europe, including the Housing Loan Recovery Colloquium held in Budapest in December, 1996. Several invitees and organizers for the Slovakia Roundtable also attended the Budapest Colloquium.

SUMMARY OF PROCEEDINGS

George Williams of USAID/Slovakia opened the Roundtable with some introductory remarks, stating that the purpose of the day's event was to try to find improved mechanisms for recovering housing loans in the event of default.

Christopher Banks then made a presentation based on *The Legal Basis for Housing Loan Recovery in Slovakia and Central and Eastern Europe: Changing to a Market-Based System*. A copy of the presentation is attached to this report as Annex E, and is briefly summarized here.

Mr. Banks' presentation outlined the importance of loan recovery in the housing finance system, and described the costs of default to lenders, borrowers, and the system itself. He then explained why a strong legal framework is necessary in order to provide a backstop and deterrent for nonpayment, and because weak laws increase the cost of loans. Mr. Banks summarized the necessary components of the legal framework for loan recovery, including enabling laws, registration laws, and enforcement laws, the latter set of laws being the focus of the Roundtable. Enforcement laws include procedures for pursuing remedies for default, including foreclosure and eviction, as well as regulating costs of execution and priority of liens.

Mr. Banks then addressed housing loan recovery in Slovakia, describing the most significant recent changes, including the adoption of Law No. 233/1995, otherwise referred as the “Execution Law.” The most significant developments in the law are the ability to use non-judicial foreclosure procedures, which should be much quicker to execute, and the omission of any language requiring lenders to provide alternative housing for those evicted for non-payment. Despite the recent legal changes, Mr. Banks noted, there has been a lack of progress in the recovery process which may be due to a number of reasons such as historical practices and cultural preferences, insufficient detail in the law on how to implement procedures, a need for additional regulations or clarification regarding forced sales and priority of debt, and the possibility that the new law is not well known or understood by the public.

Mr. Banks concluded that while Slovakia and other CEE countries have made substantial progress in improving laws relating to enforcement of the rights of mortgage lenders, lenders continue to prefer to use alternatives to foreclosure and eviction.

Dr. Klaus Peter Follak spoke next about the loan recovery situation in Slovakia from the perspective of a foreign mortgage banker actively involved in the Slovak banking sector. He began with a summary of the basic requirements for the introduction of real mortgage lending in any market, and then described a number of general problems related to the finance and execution of real estate in Slovakia. The main issues, according to Dr. Follak, include: the choice of mortgage (lien priority differs depending on commercial code or civil code); unclear priority of liens, even if using the new Execution Law; the need for sequestration/receivership of foreclosed property in addition to the forced sale option; the need for more flexibility in setting minimum bids for auction of seized property; the clarification of legal regulations, because the ranking and execution of a mortgage depends on whether it is established under the civil code or commercial code; the need to legislate the high priority of mortgage liens in order to enhance the safety and soundness of mortgage bonds; and the need for “open-mortgage” clauses to allow more flexible enforcement of liens.

Dr. Follak also discussed some specific problems related to loan recovery in the construction finance process for condominiums and made some recommendations for legal improvements, such as the establishment of preliminary title in rem for the purchaser, the obligation of banks or construction companies to release collateral provided by the purchaser when construction is finished and the full price of the unit has been paid; and the regulation of maximum prepayments by a purchaser of a condominium, following the progress of construction.

Following Dr. Follak's presentation, Eva Kukanová, Director of Legislation at the Ministry of Justice, gave an informal presentation on the Execution Law (233/1995) and related legislation. She began by discussing the role of the executioner, who is nominated by the Ministry of Justice and appointed by the state, and who must be impartial and independent. The executioner depends on the aid and cooperation of third parties in the execution process such as the land registries, banks, etc.

As stated in section 34 of the Execution Law, the first step in the execution process is for the petitioner to ask for the process to be initiated as soon as the contract between the lender and the borrower has been breached. The contract must be valid and executable. Once the proceedings are initiated, no other proceedings involving the same debtor are allowed to begin. According to Ms. Kukanová, there are two



procedural options for pursuing execution, either through the courts on the basis of the civil code, or through the executioner, who carries out the execution order on the basis of the Execution Law.

In order for the executioner to have access to the debtor's assets, the following actions must be taken: (1) a petition for distraint must be presented to the court; (2) this petition must include an execution order; (3) the order must be valid and executable; and (4) the executioner must be appointed to act according to the law and must provide the amount of funds sought, name of debtor, court where process was initiated, number of proceedings initiated, date, and the name of the creditor. Once this information is provided, the proceeding can begin. After the collateral property is "secured," the debtor is notified and has 14 days to appeal. The court must consider all objections raised by the debtor and decide whether they are valid. Ms. Kukanová explained that institutions holding assets of the debtor are required to turn over the assets to the executioner.

The amount of money owed can be turned over to the executor in a number of ways, including: (1) wages; (2) assets (bank accounts); (3) sales of movables; (4) business activities/income; and (5) sale of immovables. The executioner decides which option to use and is only limited by the total amount of money due. This is a major difference with the civil code, in which the debtor proposes which method to use and the execution process ceases if the amount due is unrelated to the object in question. Under the Execution Law, however, it is possible for the executioner to sell a house to recover only 5,000 SK due. Ms. Kukanová stressed that the law is strong in this sense because the debtor's obligations must be enforced and that the debtor's assets are subject to sale even if their value exceeds the amount due.

Under section 151(a) of the Civil Code, if the debtor does not meet his obligations, the creditor may take possession of his property. In this case, the court proceeds according to the civil code. If the claim is on an object, the court may reject the claim. Only the court can sell certain types of real estate. In this regard, the civil code prevents certain provisions of the Execution Law from being implemented, and amendments to correct this situation are now being drafted.

If the creditor is a bank, according to Ms. Kukanová, there are no legal impediments to recovering loans. This is referred to in Section 299 of the Commercial Code. However, there is no description of the process and it is therefore unclear how to proceed. Ms. Kukanová suggested the need for additional legislation, with some detailed explanations, to address this issue. As an example, she recommended making public the date of an auction; providing clear deadlines, and clarifying who will make decisions regarding claims on the collateral. In addition, certain types of public auctions have been judged illegal¹ at the Supreme Court, and there is a need for legislation governing this activity.

Ms. Kukanová also clarified one point of confusion in the Execution Law regarding notarial protocol. As stated in Section 41 of the law, the distraint title, which makes the court decision enforceable, must follow notarial *protocol*, but does not have to be *notarized* per se. According to Ms. Kukanová, this is a complicated process, but necessarily so.

¹ Apparently this concerns public auctions for liquidation of state enterprises, which has been found illegal in the absence of a bankruptcy law in Slovakia.

Kukanová then provided some information on more recent legislation affecting the execution process, including Law 218/1996. This law specifies other execution activities, including a definition of the arbitration process, although this option has not yet been applied by lenders. Under this law, disputes can be resolved by arbitration, which can be protested against only as defined by law, within 15 days. The finding of an arbitration case can then become a distraint title (court order to enforce an execution.) On a cautionary note, Ms. Kukanová warned of the need to make sure the courts do not become overburdened by this process.

Another recent piece of legislation related to loan recovery is Law 153/1997, an amendment to the Civil Code which is valid as of June 1, 1997. This legislation concerns the issue of replacement housing for the rental stock. According to Ms. Kukanová, if rent is not paid for 90 days, an owner may ask the court for permission to evict. If the court agrees, it also must decide on the need for “replacement” housing. “Replacement” is clearly defined in the Civil Code, and is only to be provided to families with minors or the disabled. In addition, the right for replacement housing does not mean equivalent housing; replacement housing can be of a lower standard. The reason why eviction rarely occurs, as allowed under other laws as well as this law, is that the courts are rarely asked to evict, not because of the legal situation, Ms. Kukanová said.

In terms of public auctions, Ms. Kukanová recommended that more dependable real estate values must be established. This is difficult in the current flat market where prices are not regulated and vary greatly. If property being auctioned is not purchased at the full value, two-thirds of the market value is allowed as an acceptable price. Ms. Kukanová also mentioned the Banking Act, article 36(j), which requires priority for mortgages serving as collateral for mortgage bonds. It is possible that someone (with a lower priority claim) requesting an execution can receive nothing from the sale of property because of other claims on the property with higher priority. A special mortgage law is now under preparation (with the Ministry of Construction and Public Works) which should resolve some of these issues.

During the afternoon session, an informal question and answer period took place, with the majority of questions coming from housing lenders or their real estate company subsidiaries, which are typically responsible for loan recovery activities. The answers were provided, for the most part, by Ms. Kukanová and by court officials.

Question: How does a bank know if an execution is taking place on property on which it has a lien?

Answer: The executioner must by law notify everyone with an interest in the property; the bank can make a claim upon notification by the executioner.

Question: Who has priority in the execution process?

Answer: Even if a mortgage right is not entered in the land registry, it still exists. If it is entered, the creditor must be informed of changes in its status. After a mortgage is paid, the mortgage right is also extinguished.

Question: Law 511/1992 states that mortgage liens are top priority; which mortgage lien has the top priority (if there are more than one)?



Answer: Priority of mortgage liens is determined by the date of the claim, with the first claim satisfied first, and so on, unless other rights exist. If claims are of equal priority, the law dictates how to proceed. For example, alimony is top priority, and then taxes. Finally proportionality is also used. For example, if two equal claims are handed in on the same day, and recovery is not total, both parties get proportional amounts.

Question: When does “execution” finish?

Answer: There is no time limit for paying back a defaulted loan. Completion of an auction does not mean the execution process is finished, because there may not be enough money from the sale of property or assets to pay all the outstanding claims.

Ms. Kukanová concluded the informal discussion stating that the Ministry of Justice hopes to complete the recodification process in Slovakia within the next 3-5 years, including the new Civil Code, Criminal Code, and a Bankruptcy Law. She also claimed that in the last 1 and one-half years, 50,000 cases have been presented to executioners in Slovakia, and of those, 25 percent have been successfully closed by the present time². In contrast, she mentioned the Banking Act, under which only 9 cases have been resolved since passage of the Act in 1991.

CONCLUSIONS AND RECOMMENDATIONS

The following conclusions and recommendations were reached by the end of the roundtable:

- Relations between executioners and banks with regard to mortgage loan recovery need to be improved.
- An execution order should be the last resort used by banks after all other methods of loan recovery have failed.
- Strong legal basis and norms are important to effective loan recovery.
- There is no real experience in Slovakia with mortgage lending in the sense that the home against which the loan is issued is rarely utilized as the primary source of loan security.
- Cooperation and information exchange, as experienced at the roundtable, are important and should be continued.
- With regard to mortgage lending in Slovakia, loans are not sufficiently secured, and real estate is often overvalued. There is a need for further development of the appraisal and valuation industries in Slovakia.

² Despite the impressive number of executions, none are known to involve the recovery of a residential mortgage loan.

- Land registration issues and reform of the cadastre system are major impediments to a stronger loan recovery system and merit more discussion. In this regard, the group agreed that it would be appropriate to organize an additional seminar in the fall concerning the issue of the land registration system and its impact on the mortgage lending market.



LOAN RECOVERY WORKING GROUP

The idea of forming a working group aimed at improving the loan recovery environment in Slovakia was suggested at the Roundtable, but there was not a clear consensus from the Roundtable attendees that such a working group is necessary or feasible. It appears that the group is more interested in discussing a broader range of legal issues and impediments to the development of mortgage lending in Slovakia (including loan recovery), and not in focusing a working group on the more narrow topic of loan recovery.

The group informally agreed, as described above, to organize a similar roundtable event in the fall of 1997 to discuss land registration reforms. It is unclear whether or not such an event will be organized without the involvement, both technically and financially, of USAID/Slovakia. Given USAID/Slovakia's budget priorities, it does not appear that any additional support will be made available for this activity, even though only a relatively modest contribution would be required to energize and organize such an event.

In any case, the Loan Recovery Roundtable accomplished its objective of informing key actors in the housing finance sector - lenders, legal experts, court officials, executors - of the importance of effective loan recovery measures and the current, evolving legislative framework governing the recovery of housing loans. An effective channel of communication has been opened among those who draft the legislation (the Ministry of Justice), those who administer and implement the legislation (courts, executioners), and the lenders who depend on the legal system to help secure their loans. It is the first step in a process which should be continued whether or not USAID continues to support it.

ANNEX A

ROUNDTABLE AGENDA

AGENDA

ROUNDTABLE ON HOUSING LOAN RECOVERY IN SLOVAKIA

June 23, 1997

-
- 9:00 Opening remarks and welcome, *George Williams, USAID*
- 9:10 The Legal Basis for Housing Loan Recovery in Slovakia and Central and Eastern Europe: Changing to a Market-Based System, *Christopher Banks, UI*
- 9:30 Presentation on the Law on Court Executors and Enforcement Activities, Law No. 233/1995; Clarifications and Explanations with Regard to Housing Loan Recovery, *Eva Kukanová, Ministry of Justice*
- 10:00 Foreign Perspective on Slovak Loan Recovery Environment, *Klaus Peter Follak, Hypo-Bank, Munich, Germany*
- 10:20 Coffee Break
- 10:40 Open discussion, moderated by *Viktoria Mučková of the NBS, Institute of Monetary Studies* :
- current status of housing loan market and loan recovery operations (bank presentations);
 - application of legal framework in the current context;
 - court/executioner experience under law 233/1995;
 - identification of impediments to the implementation of loan recovery procedures as allowed under the law.
- 12:15 Lunch (provided)
- 1:00 Open discussion, moderated by *Viktoria Mučková*
- identification and consensus on key issues to address to strengthen loan recovery in Slovakia,
 - discussion of recommendations and next steps
- 2:15 Summary of key recommendations and next steps, *Jaroslava Zapletalová, Ib and Viktoria Mučková, IMS*
- 2:30 Closing of roundtable

Sponsor: USAID/Bratislava
Technical Support: National Bank of Slovakia, Institute of Monetary Studies
Slovak Savings Bank
Organizers: Inštitút bývania (Ib)
The Urban Institute (UI), Washington, D.C.
Location: Savings Bank Academy, Záhradnícka 95, OC Starý Ružinov

ANNEX B

THE LEGAL BASIS FOR HOUSING LOAN RECOVERY IN CENTRAL AND EASTERN EUROPE

CHANGING TO A MARKET-BASED SYSTEM

**THE LEGAL BASIS FOR HOUSING LOAN RECOVERY
IN CENTRAL AND EASTERN EUROPE**

CHANGING TO A MARKET-BASED SYSTEM

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June 1997

THE LEGAL BASIS FOR HOUSING LOAN RECOVERY IN CENTRAL AND EASTERN EUROPE

CHANGING TO A MARKET-BASED SYSTEM

INTRODUCTION

Background

Countries undergoing economic restructuring in the post-socialist era have found housing to be critically important to the difficult transition to market-based economies. To a large extent, the attitudes of people about their overall quality of life reflect their level of satisfaction with their own living conditions. Because no other sector directly affects the lives of such a large portion of the population, housing has profound political and social implications beyond its importance to the economic sphere.

In both Western Europe and the United States, government agencies have played a significant role in helping more families improve their housing standards and achieve home ownership by increasing the availability of private mortgage finance. They encourage home ownership both because it is politically popular and because it contributes significantly to the economy as a whole. Lenders in developed market economies aggressively pursue the residential borrowing market because it is regarded as profitable and secure. This has yet to happen in CEE countries, including Slovakia, but there is no reason to believe that mortgage finance will not develop in this way in the future.

Costs of Default

Unfortunately, not all mortgage loans are repaid. Rates of default vary significantly with the type of loan and the individual attributes of the borrower, in addition to external, macro-economic conditions. Mortgage default is very expensive for any housing finance system. For lenders (and, in developed economies, for the institutions that guarantee and insure home mortgage loans), costs include the administrative and legal expenses of trying to collect loans in default, and the loss incurred when the net cash recovered from a foreclosure sale is less than the balance of the loan on the property that is used as collateral. When there is a high level of mortgage default, mortgage borrowing becomes more expensive or may even cease to be available at all.

A borrower who defaults also suffers losses, including a lower credit rating, legal expenses, lost work time, the emotional distress of dealing with legal proceedings, and ultimately the loss of his property.

Minimizing default loss serves the interests not only of lenders, borrowers, and government agencies, but also the many private businesses and services that depend on a vibrant, efficient real estate market.

Lenders' Choices in Cases of Default

When a mortgage loan is in default, lenders have a number of choices available to them. They can simply wait to see if the borrower begins to pay again, they can attempt to resolve the problem by to

negotiating with the borrower, or they can initiate one or more of the legal remedies available under the law and the relevant loan documents.

Lenders choose from among these options, and decide how long to wait before acting, on the basis of business judgment. For example, if the lender determines that the borrower has a good credit record and is not paying because of a temporary illness or financial setback, the lender can decide to renegotiate the terms of the loan in a way that allows the borrower to recover and resume payments. If the lender decides that the borrower's ability or willingness to pay is not likely to change in the near future, the lender can pursue various legal remedies, including collection from third-party guarantors, attachment of the wages of the borrower, or foreclosure and sale of the mortgaged property to recover the unpaid mortgage balance, interest, and costs.

The relative merits of these different options must be examined by evaluating the amount of time, expense, and difficulty involved in implementing each of them, and the likelihood of success each of them provides in recovering all, or at least a substantial part, of the money owed to the bank.

To make an appropriate business judgment, the lender must be familiar with the legal framework applicable to mortgage lending and debt collection, since this is a critical factor in deciding which option to pursue.

WHY IS A STRONG LEGAL FRAMEWORK NECESSARY?

Strong Laws Are a Backstop for Nonpayment

The legal framework is an essential component of the entire mortgage lending system, yet the system is predicated on the assumption that a very large percentage of borrowers will repay their loans. This apparent contradiction can be resolved by thinking of the legal framework as the “backstop” or the “last resort” in the process. In an ideal world, lenders would never have to use it. But the world is not ideal, defaults do occur, and sometimes legal action must be taken.

Strong Laws Deter Nonpayment

The legal framework is important as a backstop, but perhaps it is even more important as a deterrent to loan default. If the borrower knows he must pay or the bank will have the power to take part of his wages or even take away his home, he will do everything possible to avoid a default. On the other hand, if he knows the goal of the legal system is to protect his individual interests and to keep him in his home, even at the expense of the lender and all the other parties involved, the borrower will have little incentive to pay other than his own good intentions.

There are many positive attributes of a market-based system, but the current transition places many demands on the pocketbook of the average person, threatens employment stability, and has made a wide range of consumer goods available which compete with housing expenditures for consumers' limited resources. So even a borrower's good intentions sometimes are not enough to keep his loan payments



current. The legal system must help to assure that mortgage borrowers repay their loans so that credit will be available and affordable for many people.

Weak Laws Increase the Cost of Loans

In addition to assessing the strength of the legal framework in choosing from among their options when a loan is in default, lenders look at the strength of the legal framework to evaluate their credit risk in making a mortgage loan. The risk that must be measured in “pricing” a loan is not only the likelihood of default, but also the cost of collection in the event of default. Weak laws make collection a lengthy and expensive process, even if collection efforts are ultimately successful. Banks must compensate for this risk by increasing the cost of the loan to the borrower. If the risk is great, the lender may be forced to charge such high rates of interest that the loans become unaffordable to most people, or may refuse to make mortgage loans at all.

Conversely, sometimes lenders underestimate the strength of the legal framework, and either price loans higher than necessary (and thus discourage borrowers), or refuse to make loans that would have been sufficiently safe and profitable.

NECESSARY COMPONENTS OF THE LEGAL FRAMEWORK

To evaluate the legal framework for mortgage lending, it is necessary to evaluate three kinds of laws: (1) enabling laws, which allow real estate to be used as collateral for a loan; (2) real property registration laws, which provide evidence of the lender's security interest; and (3) enforcement laws, which give the lender the right to take possession of the collateral and other assets of the borrower, and sell them to satisfy the debt if the borrower defaults. This paper is concerned primarily with enforcement laws, an important subset of which is the regulation of foreclosure and eviction.

Enabling Laws

Enabling laws provide that a mortgage is a property right that can be used to secure a lender's claim for payment of the debt. Enabling laws give the owner the ability to use his property as collateral to obtain a loan. They provide the lender with strong security by affording the right to place a lien on immovable property, and the option to seize and sell the property if the borrower defaults on loan payments.

Registration Laws

Laws relating to creation and administration of a system for real property registration provide for a system of records demonstrating ownership or title, and the existence of other interests or property rights affecting the real property, including mortgages, other liens, easements, servitudes, and the like. Property records do not just indicate ownership or other facts about real property; they usually constitute legal evidence of ownership and the existence of other interests, including a lender's security interest.

The law must provide clear, efficient titling and registration procedures to show the actual legal status of each property at any given time. There must be public access to these legal records, the information and its significance must be transparent, and the records must be accurate, reliable, and up to date.

Enforcement Laws

Laws relating to enforcement of mortgage obligations regulate the procedures under which the lender may pursue remedies for default, including access to the collateral or other assets of the borrower. Often, they also regulate the costs and expenses likely to be incurred in pursuing these remedies. These laws should include clear, efficient foreclosure procedures, so that in the event of default the lender can acquire access to and use of the property that was used to secure the loan. They must enable the lender to evict the borrower after foreclosure, if necessary, so the property can be sold free of occupants.

Enforcement laws set out the priority of liens in the case that there is more than one. Since priority may be based on factors others than sequence of registration, the registration records themselves might not establish the priority. It is important that the law provide the mortgage lender with a reasonable position in the order of payment from the proceeds of the sale of the mortgaged property or other assets of the borrower, so that the lender has a realistic opportunity to recover the balance due on the loan.

PROGRESS IN REFORMING THE LEGAL FRAMEWORK IN CEE

Pre-Transition Legal Issues

In the early 1990s, international donors conducted a number of studies of the housing finance systems in CEE as part of their efforts to assist with the transformation to a market-based economic system. They learned that the planned economies were stable from a macro-economic standpoint, and financial terms for housing loans were remarkably soft, with long repayment terms and deeply subsidized interest rates.

Lenders making residential loans did not rely primarily on the property itself as security for the loan in case of default, but were far more likely to use remedies such as garnishment of the borrower's wages and collection from guarantors, including garnishment of the guarantor's wages. Because the lender was a state-owned or controlled bank, and the state at least implicitly guaranteed employment to citizens working in state-owned or controlled enterprises, there was essentially a closed system in which wages were reliable and wage garnishment could be used easily and effectively to collect from borrowers in default. True mortgage financing was not necessary and rarely used.

In the early studies, there were two recurring conclusions about the suitability of the pre-transition legal framework for housing finance in a market economy. The first is that laws allowed a borrower to use his property as collateral to secure a housing loan; in other words, mortgage lending was a legal possibility. The second is that other pre-transition laws, regulations, and firmly entrenched practices made security for mortgage loans so weak that true mortgage lending was simply not feasible from a market standpoint.



There were several important reasons for the conclusion that market-based mortgage lending was not feasible under the old laws. The first is that in almost all cases, foreclosure and execution of a mortgage loan involved a very long, expensive judicial procedure, or even a series of procedures. The prospect of being tied up in court for several years made foreclosure an extremely unattractive option to lenders. Second, even if the lender were willing to go to court, and succeeded in obtaining a transfer of title to the property, the lender still might not have meaningful access to the property so it could be sold to cover the borrower's debt. In order to evict the borrower, the lender had to initiate additional execution procedures (sometimes involving additional court hearings), and had to provide the evicted family with alternative housing. Just this one requirement — the need to have a stock of housing units to hand over to borrowers who default on mortgage loans — would deter many lenders from entering the housing loan market.

Recent Changes to Minimize Credit Risk

With increased uncertainty of employment, and inability on the part of central governments and state banks to sustain formerly generous subsidies, the macroeconomic factors underlying the old housing finance systems in CEE are no longer present. Countries in transition are looking toward systems based on the principles of the market economy, and are reforming their laws accordingly.

Through a lot of careful thought and hard work, the most serious **legal** impediments to mortgage lending have been eliminated in most countries in CEE. These changes are too recent to provide more than anecdotal information about their effect on risk assessment and default rates. Moreover, most banks in the region have not yet adopted policies of strict and speedy enforcement, so new procedures remain largely untested.

The most significant changes include the following:

- The requirement for a judicial proceeding before sale of the property by the lender has been eliminated, as long as the loan documents have been prepared in accordance with procedures mandated by new laws.
- The requirement that a lender provide alternative housing when evicting a borrower after foreclosure has been eliminated.
- Steps have been taken to improve the speed and cost-effectiveness of execution procedures, which have been streamlined under enforcement laws adopted in the last year or so.
- Efforts are underway to improve the speed and accuracy of titling and registration systems, largely through computerization and training of personnel. In general, most countries in the region have adequate, if somewhat antiquated, pre-war registration systems; the problems are more administrative than legal in nature, and will take time and a great deal of money to resolve.

Description	Poland	Czech Republic	Slovakia	Hungary	Croatia	Western Europe	United States
Efficient registration procedures	No	Yes	Yes	Yes	No	Yes	Yes
Non-judicial foreclosure available	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Clear and efficient execution procedures	No	Yes	Yes	Yes	Yes	Mixed	Yes
Adequate position of mortgages in priority of liens	No	No	Yes	No	?	Yes	Yes
Ability to evict defaulting borrower	Yes	Yes	Yes	Yes	Yes	Yes	Yes
No substitute housing requirement for eviction	Yes	No	Yes	Yes	Yes	Yes	Yes

Note:

Denotes Western Europe, in the sense that most countries in the region are generally in agreement with the statement.



LOAN RECOVERY IN SLOVAKIA

Slovakia has made several important changes in its legal framework to expedite enforcement of loan recovery, including elimination of the requirement for a judicial procedure for foreclosure, and elimination of the requirement to provide substitute housing to an evicted borrower. These changes were accomplished through the adoption of a new Law on Court Executors and Enforcement Activities, Law No. 233/1995. Law. 233 provides in pertinent part of Section 41(2):

Distrainment according to this law may also be performed based on notarial protocols which contain a legal commitment and which identify the obligee and the obligor, the legal reason, the object, and the term of performance, provided that the obligor has agreed on distrainment in the notarial protocol.

The paragraph has been interpreted³ to mean that the parties to a mortgage loan may agree that in case of the borrower's default, the lender is entitled to take possession of the property used to secure the loan and to evict the borrower without a judicial procedure and without providing alternative housing for the borrower, as long as the parties have agreed to these procedures in a notarized document.

This provision of the law represents a major advancement in the legal framework for housing finance in Slovakia. However, in practice, it seems to have had little effect on risk assessment, risk management, or loan recovery practices. The reasons why the law is not being used are not clear but may include some or all of the following:

- Law No. 233 and its significance are not well known or not understood, even among lenders.
- Historical practices and cultural preferences are so entrenched that lenders prefer not to use these procedures.
- The law provides insufficient detail about how the procedures are to be implemented and must be supplemented with additional regulations. For example, additional regulations are needed to provide procedures for conducting non-judicial foreclosure sales or auctions, including a description of the rights of the parties during and after the sale or auction, and for addressing the problem of occupants who refuse to vacate the premises. Priority of mortgage debt could also be improved, although this will probably require changes to other legislation such as the Civil or Commercial Codes.

Thus, one must analyze the strengths and weaknesses of the loan recovery system on two levels. First, it is necessary to understand why the important rights already available to lenders are not being more widely used. It is clear that simply passing legislation does not automatically result in changes in practice. Lenders are not taking advantage of the strengthened non-judicial foreclosure and eviction procedures now available under Law 233 (for example, by requiring notarized loan documents that spell out the lender's rights

³ The interpretation of this paragraph is informal, that is, to the author's knowledge, it has not been presented in a court proceeding.

in case of default,) despite the fact that these procedures could be expected to reduce credit risk. It would be useful to learn why this is true, so that effective measures could be taken to encourage lenders to use the important new rights that are already available to them. Second, it is necessary to fill in the gaps in the legal framework by adopting laws or regulations to help effectuate the lenders' new rights. The rights to foreclose without a trial and to evict without substitute housing may exist in the law, but if lenders are uncertain about exactly how to carry out sale of the property and eviction of the occupant (if necessary), these rights will remain largely meaningless and will go unused.

CONCLUSIONS

- Housing finance plays an important role in the social, political, and economic well-being of a country.
- The cost and consequences of mortgage default can be reduced by the existence of a strong legal framework.
- Countries in the region, including Slovakia, have made substantial progress in improving laws relating to enforcement of the rights of mortgage lenders, primarily by eliminating the requirement of a judicial procedure before foreclosure and the need to provide alternative housing to an evicted borrower.
- Despite these changes, lenders have continued to use alternatives to foreclosure to protect their interests and to collect loans in default.
- Countries in the CEE region will continue to harmonize their laws and practices with those of Western Europe and they move toward cross-border transactions and strive for membership in the European Community.

ANNEX C

PAPER ON THE LOAN RECOVERY SITUATION IN SLOVAKIA

LOAN RECOVERY SITUATION IN THE SLOVAK REPUBLIC MORTGAGES: RECOMMENDATIONS

PAPER ON THE LOAN RECOVERY SITUATION IN SLOVAKIA

by Klaus Peter Follak

BASIC REQUIREMENTS RELATED TO THE INTRODUCTION OF MORTGAGE CREDIT AND LENDING AGAINST REAL ESTATE COLLATERAL

- Clear establishment of property rights and clear titles.
- Efficient establishment of bank security rights.
- Speedy execution of property-related transactions at feasible costs.
- Clear planning law and planning consents as a reliable basis for the value of the collateral.
- Liberal law of landlord and tenant as a basis for the rental value of the property.
- Additionally, regulation of credit-related professional valuations would be helpful.
- Clear and sound regulation of mortgage banking and mortgage-backed securities.
- Economically, monetary stability to a certain extent and the development of open real estate markets are necessary.

GENERAL PROBLEMS RELATED TO PROPERTY FINANCE AND EXECUTION

Insufficient enforcement of bank collateral is broadly related with risks concerning the safety and soundness of banks. This problem is particularly severe as long as these institutions have not yet built up sufficient reserves. Clear security titles would be a pre-condition for the establishment of capital markets on the basis of mortgage-backed securities, because related risks would affect the safety and soundness of such bonds.

An overall adoption of alien legal systems is not a realistic alternative. Basically, a good stock of laws exists which might require appropriate amendment and improvement but not a fundamental reshuffle.

With regard to the mortgage, two fields of problems can be identified:

- Clear definition and rank of the charge; and
- Execution of the charge.

Regarding ranks of collateral and execution, old legislation exists alongside new. Additionally, loan contracts and mortgages can be established both under the civil code or under the commercial code. Mortgages under the civil code can only be executed according to the regulations of the ZPO or under the Law 233/95, i.e. by public auction performed by the courts or by the court executors. A choice between these two laws - the ZPO or Law 233/95 - may imply significant consequences, because the order of preferences between the individual claims realized in an execution following article 157 of the Law 233/95 differs from the one following the ZPO. If the mortgage has been established under the commercial code, both parties may agree an private sale or private auction as well. As a result, four alternatives for enforcement exist:

- Mortgages under the civil code or the commercial code: following. the ZPO (basically old legislation).

- Mortgages under the civil code or the commercial code: following law 233/95 (basically new and detailed legislation).
- Mortgages under the commercial code: private auction is possible, but there does not exist any legislation on this alternative.
- Mortgages under the commercial code: private sale is possible, but there does not exist any legislation either, especially for the legal basis of the change of ownership. In practice this means for example that the land registrar would enter the new owner into the book only in case a prior written agreement exists.

These various alternatives should be harmonized, and legislation on private auction and on execution by private sale should be drafted.

Even following the introduction of Law No. 233, the position of mortgages in priority of liens and encumbrances seems not yet quite adequate, although practitioners try to solve related problems by means of supplementary interpretation, it seems that the various items included in article 157(c) of Law No. 233 shall have equal rank. This means that any order of preference between several mortgages or between mortgages and encumbrances would not exist. In case of public auction, encumbrances have to be taken over by the person awarded the bid. This rule might involve significant economic risks for the purchaser, e.g. rights of habitation in favor of third parties etc. A clear ranking between several mortgages and between mortgages and encumbrances is recommended, which should basically follow the date of entry into the land registry. In case the mortgage is executed, all encumbrances which are overruled by the mortgage should expire.

According to present legislation, mortgages can only be realized by forced sale but not by sequestration/receivership. This means that only the market value of the property itself is subject to execution but not the current income of the property, in particular rental payments, as a separate economic value. Sequestration, by contrast, would be a more lenient way of execution, because in this case only the current income out of the property would be seized. Therefore, the introduction of sequestration is strongly recommended.

In case of forced sale by public auction, the minimum bid is restricted to the valuation and may not fall short of this: price, even in case of repeated auction or in case the property cannot be sold at this price. This might be an obstacle to speedy realization and the bank itself might have to bid in order to sell the property later when the market might have improved. Therefore, in case of a repeated auction a bid below the officially estimated market value should be admissible.

According to present legislation, the ranking in an execution depends on whether the mortgage has been established under the civil code or under the commercial code. Fiscal claims, however, would benefit from priority in any case. The problem is that neither the existence nor the amount of these overriding claims can be recognized in the land register. Therefore, the actual value of a charge is not foreseeable from the creditor's point of view. In order to establish clear mortgage titles with a reliable ranking, at least the maximum amounts of these overriding claims should be fixed. The best solution from the creditor's point of view would be the requirement of the entry into the land register and a ranking following the date of such



entry for every claim apart: from those claims which are directly related to the property, e.g. council rates (land taxes.) Therefore, additional codification regarding the ranking of charges on property is recommended.

The safety and: soundness of mortgage bonds and hence their market acceptance hinges on the enforceability of the underlying mortgages. Article 36(j) of the Bank Act requires priority for mortgages serving as a collateral for mortgage bonds. This requirement should be implemented in civil law and in legislation on the execution of mortgages.

According to present legislation, mortgages are strictly accessory, i.e. the legal force of the mortgage depends on a specific underlying claim which cannot be exchanged. It might be useful to introduce certain open-mortgage clauses or a mortgage on its own right which would be legally independent from a specific underlying claim. This instrument could serve as a collateral for a variety of claims with fluctuating amounts and would facilitate refinance transactions by assigning mortgages.

SPECIFIC PROBLEMS RELATED TO CONSTRUCTION FINANCE/CONDOMINIUMS

Frequently, for the construction of condominiums a single-purpose cooperative is established, serving as a preliminary owner of the property during the construction period. The purchasers of the condominiums would be shareholders of the cooperative. Following the completion of the construction, the condominium titles would be transferred to the specific purchasers, i.e. the cooperative would be privatized.

The problem is that the purchaser does not have a contingent interest in the sense of a real preliminary title in rem (interest in the property) but only a contractual right of future purchase. Therefore, the purchaser would not be eligible for a mortgage at this stage, i.e. his downpayments cannot be financed against real security. If, on the other hand, loans against real security (the construction) would be granted to the cooperative company, prepayments by the purchaser would be unsecured and would be used up in the course of the construction.

Therefore, three legal issues can be recommended:

- Establishment of a preliminary title in rem for the purchaser, including a clear ranking position in the land register.
- Banks financing cooperatives or construction companies should be obliged to release related collateral supplied by the purchaser of a condominium, as soon as the construction has been completed and the purchaser has paid the full price of his specific unit.
- A legal schedule with maximum amounts of prepayments by the purchaser of a condominium should be issued, following the progress of the construction.

Due to these measures, also concur-rent financing of the cooperative or the construction company and the future purchaser would be enabled. The proposed scheme could be also used in case of construction companies, where the future purchasers do not participate, as shareholders.

LAW OF LANDLORD AND TENANT

Open market financing of residential properties basically requires a market-oriented rental system which might be introduced step by step, because the value of rented property hinges on it. In Slovakia, the basic rental price is regulated and subject to reassessment from time to time. In East Germany and in the Czech Republic renting out newly built accommodation is liberalized, As a consequence, even in these countries refurbishment of older dwellings has to be undertaken stop by step following the liquidity of the permitted rent increase. This liquidity would also be the upper limit of possible debt payments.

LOAN RECOVERY SITUATION IN THE SLOVAK REPUBLIC MORTGAGES

RECOMMENDATIONS

by Klaus Peter Follak

An overall adoption of alien legal systems is not a realistic alternative. Basically, a good stock of laws exists which might require appropriate amendment and improvement but not a fundamental reshuffle.

- The various alternatives of execution under the Civil Code and the Commercial Code, Law 233/95 and the OSP should be harmonized, and legislation on private auction and on execution by private sale should be drafted.
- A clear ranking between several mortgages and between mortgages and encumbrances is recommended which should basically follow the date of entry into the land register. In case the mortgage is executed, all encumbrances which are overruled by the mortgage should expire. Accordingly, a ranking between the items included in article 157(c) of Law 233/1995 should be introduced.
- Sequestration/receivership should be introduced as an additional alternative to forced sale.
- In case of a repeated auction, a bid below the officially estimated market value should be admissible.
- Regarding legal mortgages, at least maximum amounts of these overriding claims should be fixed. The best solution would be the requirement of the entry into the land register and a ranking following the date of such entry for every legal mortgage apart from those claims which are directly related to the property, e.g. council rates (land taxes).
- Article 36(j) of the Bank Act requires priority for mortgages serving as a collateral for mortgage bonds. This requirement should be implemented in civil law and in legislation on the execution of mortgages.
- It might be useful to introduce certain open-mortgage clauses or a mortgage on its own right which would be legally independent from a specific underlying claim and hence could serve as a collateral for a variety of claims with fluctuating amounts.

- Regarding construction finance/condominiums, three legal issues can be recommended:
 - Establishment of a preliminary title in rem for the purchaser, including a clear ranking position in the land register.
 - Banks financing cooperatives or construction companies should be obliged to release related collateral supplied by the purchaser of a condominium, as soon as the construction has been completed and the purchaser has paid the full price of his specific unit.
 - A legal schedule with maximum amounts of prepayments by the purchaser of a condominium should be issued, following the progress of the construction.
- Open market financing of residential property basically requires a market-oriented rental system which might be introduced step by step, because the value of rented property hinges on it. As a first step, renting out newly build accommodation might be liberalized.

ANNEX D

LIST OF ATTENDEES AND LETTER OF INVITATION

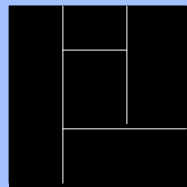
ANNEX E

THE LEGAL BASIS FOR HOUSING LOAN RECOVERY IN SLOVAKIA AND CEE

CHANGING TO A MARKET-BASED SYSTEM

The Legal Basis For Housing Loan Recovery in Slovakia and CEE: Changing to a Market- Based System

Christopher Banks



The Urban Institute

ESTABLISHING THE LEGAL BASIS FOR HOUSING LOAN RECOVERY - INTRODUCTION -

- ◆ **ROLE OF HOUSING IN CEE ECONOMIC TRANSITION**
- ◆ **COSTS OF DEFAULT**

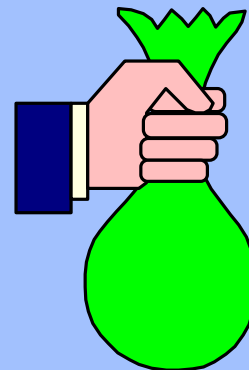
- ◆ Costs to lender
- ◆ Costs to borrower
- ◆ Costs to the housing finance system
- ◆ Costs to other businesses and services

LENDERS' CHOICES

- ◆ Wait and see
- ◆ Negotiate
- ◆ Take legal action

WHY IS A STRONG LEGAL FRAMEWORK NECESSARY?

- ◆ **STRONG LAWS ARE A BACKSTOP FOR NONPAYMENT**
- ◆ **STRONG LAWS ARE A DETERRENT TO NONPAYMENT**
- ◆ **WEAK LAWS INCREASE THE COST OF LOANS**



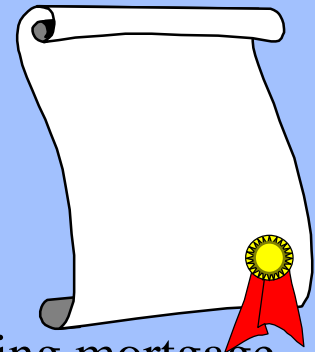
NECESSARY COMPONENTS OF THE LEGAL FRAMEWORK

◆ ENABLING LAWS

- ◆ Real property can be used as collateral for a loan
- ◆ Mortgage is a property right that can secure a debt
- ◆ Lender has a right of access to the property in case of default
- ◆ Borrower protection (disclosure laws)

◆ REGISTRATION LAWS

- ◆ Evidence of ownership or title
- ◆ Evidence of existence of other interests, including mortgage
- ◆ Indicate actual legal status of property
- ◆ Public, transparent, accurate, reliable, up to date



NECESSARY COMPONENTS OF THE LEGAL FRAMEWORK

◆ ENFORCEMENT LAWS

- ◆ Procedures for pursuing remedies for default
- ◆ Regulate costs
- ◆ Foreclosure and eviction procedures
- ◆ Priority of liens



PROGRESS IN REFORMING THE LEGAL FRAMEWORK IN CEE

◆ PRE-TRANSITION LEGAL ISSUES

- ◆ Mortgage lending was possible, but rarely used
- ◆ Other security was adequate
- ◆ Legal framework for mortgage lending was very weak

◆ BASIC WEAKNESSES IN LEGAL FRAMEWORK

- ◆ Foreclosure & eviction required long, costly court procedures
- ◆ Evicted borrower entitled to alternative housing

◆ RECENT CHANGES

- ◆ Elimination of judicial procedure requirement
- ◆ Elimination of alternative housing requirement
- ◆ Increased speed & lower cost of execution procedures
- ◆ Efforts underway to improve registration procedures

LOAN RECOVERY IN SLOVAKIA

◆ RECENT CHANGES

- ◆ Adoption of Law No. 233/1995
- ◆ Use of non-judicial foreclosure possible
- ◆ No alternative housing requirement

◆ POSSIBLE REASONS FOR LACK OF PROGRESS

- ◆ Law is not well known or understood
- ◆ Historical practices and cultural preferences
- ◆ Law provides insufficient detail on how to implement procedures
- ◆ Additional regulations or clarifications are needed regarding forced sales and priority of debt

LOAN RECOVERY IN EU COUNTRIES

◆ NOT UNIFORM, BUT FUNDAMENTALLY SIMILAR

- ◆ Cross-border transactions are possible
- ◆ Lack of uniformity helps preserve fair competition

◆ IMPROVEMENTS NEEDED

- ◆ Reduce time needed for foreclosure and execution
- ◆ Harmonize registration systems
- ◆ Restrict "hidden" or nondisclosed liens
- ◆ Harmonize priority of liens and distribution of proceeds



CONCLUSIONS

- ◆ **Housing Finance plays an important role in the political and economic well-being of a country.**
- ◆ **The costs and consequences of mortgage default can be reduced by the existence of a strong legal framework.**
- ◆ **CEE Countries, including Slovakia, have made substantial progress in improving laws relating to enforcement of the rights of mortgage lenders.**
- ◆ **However, lenders will continue to use alternatives to foreclosure and eviction.**
- ◆ **Slovakia will most likely continue to harmonize laws and practices with the EU.**